

[HIGH COURT OF AUSTRALIA.]

THE MIDLAND RAILWAY COMPANY OF }
 WESTERN AUSTRALIA LIMITED. . } APPELLANT ;

AND

FEDERAL COMMISSIONER OF TAXATION RESPONDENT.

H. C. OF A. *Income Tax (Cth.)—Assessment—Deductions—“ Losses and outgoings to the extent*
 1950. *to which they are incurred in gaining or producing the assessable income, or*
 } *are necessarily incurred in carrying on a business for the purpose of gaining*
 PERTH, *or producing such income ”—Method of paying interest to holders of cumulative*
income debenture stock altered by issue of reversionary certificates—Certificates
redeemable out of profits—Whether redemption payments allowable deductions—
 SEPT. 23. *Income Tax Assessment Act 1936-1944 (No. 27 of 1936—No. 28 of 1944),*
 SYDNEY, *s. 51 (1).**
 NOV. 21.
 Kitto J.

The tax-payer company was incorporated in England and was carrying on business in Western Australia. In 1902 the company issued certain cumulative income debenture stock which stock entitled the holders thereof to interest at the rate of six per cent per annum from 30th June 1898, payable only out of the surplus revenue of the company. The company, in fact, did not have any surplus revenue at any time during the twelve years ending 30th June 1910, and interest for that period amounted to £701,080. In the year 1910 the company reduced its share capital and re-organized its share and loan capital, and the six per cent cumulative income debenture stock was satisfied by issuing to the holders, *inter alia*, reversionary certificates to the total value of £701,080. These certificates were issued on conditions which provided that one-third (later reduced to one-sixth) of the net profits of the company which from time to time the directors should determine to divide should be applied in their redemption. In the year ending 30th June 1943 the company set aside a certain sum out of profits for that year as a

* Section 51 (1) is in the following terms :—“ All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income,

shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.”

provision for redemption of reversionary certificates and the money was, in fact, spent for that purpose in the ensuing year. The company claimed a deduction of the amount expended in the redemption of the certificates under s. 51 (1) of the *Income Tax Assessment Act* 1939-1944 and the claim was disallowed by the commissioner.

On appeal to the High Court, *Held*, that the reversionary certificates were issued in respect of the £701,080 unpaid interest on the six per cent cumulative income debenture stock but did not operate as a payment or satisfaction of such unpaid interest and the amounts paid in redemption of the reversionary certificates, being in the nature of payments of interest on moneys borrowed by the company for the purpose of its business, were allowable deductions in the year in which the certificates were redeemed.

Distinction between the expressions "net profits" and "assessable income" discussed.

H. C. OF A.
1950.
MIDLAND
RAILWAY
CO. OF
WESTERN
AUSTRALIA
LTD.
v.
FEDERAL
COMMISSIONER OF
TAXATION.

APPEAL under *Income Tax Assessment Act*.

The Midland Railway Company Limited appealed to the High Court against an assessment to Federal income tax based upon income derived by the company during the year ending 30th June 1944.

The appeal was heard by *Kitto J.*, in whose judgment the facts and argument are sufficiently set forth.

R. I. Ainslie for the appellant.

F. W. Leake K.C. and *A. L. Gleedman* for the respondent.

Cur. adv. vult.

KITTO J. delivered the following written judgment:—

Nov. 21.

This is an appeal against an assessment by the respondent of the income tax payable by the appellant in accordance with the *Income Tax Assessment Act* 1936-1944, in respect of the income derived by the appellant during the year ended 30th June 1944.

The appellant is a company incorporated in England and carrying on business in Western Australia. Its income tax return in respect of the relevant year stated its taxable income as being £286,582 "as per attached reconciliation statement". The return was accompanied by copies of its balance sheet, revenue accounts relating to Australia and London respectively, a combined revenue account expressed in Australian currency, and a reconciliation statement by which the difference between the balance shown by the combined revenue account and the taxable income shown in the income tax return was accounted for.

H. C. OF A.
1950.

MIDLAND
RAILWAY
CO. OF
WESTERN
AUSTRALIA
LTD.

v.
FEDERAL
COMMISSIONER OF
TAXATION.

Kitto J.

The reconciliation statement disclosed that the company had treated as an allowable deduction a sum of £2,966, described as being “funded interest paid during year on 14/6/44 by redemption of Reversionary Certificates redeemable only out of the profits of the Company in accordance with the provisions of—(1) Special Resolutions of 29th September 1910, confirmed 14th October 1910, (2) Trust Deed securing Reversionary Certificates dated 15th April 1911, (3) Supplementary Trust Deed dated 8th June 1925”. The sum of £2,966 had in fact been set aside out of the profits of the year ended 30th June 1943 as a provision for redemption of reversionary certificates, and had been expended by the company for that purpose as stated in the reconciliation statement.

It was also disclosed by the balance sheet and revenue accounts that in the year ended 30th June 1944 the company had made out of its profits a provision amounting to £3,089 (shown therein in sterling as £2,471) as an amount to be applied for “redemption of Reversionary Certificates, being the sum applicable for that purpose in terms of the Trust Deed.” This sum was in fact expended during the year ended 30th June 1945 in redemption of reversionary certificates.

On 20th December 1945, the respondent issued to the company a notice of assessment, accompanied by particulars of alterations showing that the company’s claim to treat the £2,966 as an allowable deduction had been rejected. On 7th January 1946 the company lodged an objection to the assessment on the grounds that the amount of £2,966 should have been allowed as a deduction under s. 51 of the *Income Tax Assessment Act*, or, alternatively, that the sum of £3,089 should have been so allowed. The objection was disallowed, and at the request of the company it was treated as an appeal and forwarded to this Court.

It is necessary to go into some detail in order to understand the nature of the company’s expenditure upon redemption of reversionary certificates.

In 1899 the company evolved a plan for the re-organization of its loan capital. Pursuant to that plan it issued in 1902 certain six per cent cumulative income debenture stock to the amount of £973,723, by way of conversion of a pre-existing issue of six per cent debentures which (as was agreed before me) had been issued for the purpose of obtaining capital for the carrying on of the company’s business. This stock entitled the holders thereof to interest at the rate of six per cent per annum on the capital amount thereof from 30th June 1898, payable only out of the surplus revenue of the company after providing for interest on certain

prior debentures and debenture stock and other revenue charges. The company in fact did not have any such surplus revenue at any time during the twelve years ended 30th June 1910, and consequently no interest on the six per cent cumulative income debenture stock became payable or was paid during the period from 30th June 1898 to 30th June 1910. The interest for that period amounted to £701,080.

The company then prepared a scheme for the reduction of its share capital and for the re-organization of its share and loan capital consisting of the following:—(a) £300,000 four per cent government-guaranteed debentures, with current arrears of interest; (b) £77,404 prior lien debenture stock, with current arrears of interest; (c) £129,923 five per cent cumulative income debenture stock, with arrears of interest; (d) the £973,723 six per cent cumulative income debenture stock abovementioned, with a contingent liability to pay interest as above stated; (e) 200,000 ordinary shares of £6 each, paid up to £1 each; and (f) 40,000 founders' shares of £1 each, fully paid.

The scheme was adopted by a special resolution passed and confirmed by the company on 29th September 1910 and 14th October 1910 respectively. It was also approved by the various classes of holders of debentures and debenture stock and by the holders of ordinary shares and founders' shares respectively, and the reduction of share capital for which it provided was confirmed by the High Court of Justice in England, the order and a minute approved thereby being duly registered as required by the *Companies Act* 1908 (Imp.).

The scheme provided, *inter alia*, that there should be created £600,000 four per cent second mortgage cumulative income debenture stock and that the existing £973,723 six per cent cumulative income debenture stock should be satisfied by the issue to the holders thereof, to be divided amongst them in proportion to their holdings, of the said £600,000 second mortgage cumulative income debenture stock, 519,781 new ordinary shares of £1 each to be issued fully paid, and reversionary certificates to the total amount of £701,080; and it provided that these should be accepted in full satisfaction of all claims to principal moneys, premium and interest in respect of the six per cent cumulative income debenture stock.

To carry the scheme into effect so far as the reversionary certificates were concerned, an indenture dated 15th April 1911 was executed by the company and certain trustees. The indenture recited the issued debenture and share capital of the company at

H. C. OF A.
1950.

MIDLAND
RAILWAY
CO. OF
WESTERN
AUSTRALIA
LTD.

v.
FEDERAL
COMMISSIONER OF
TAXATION.

Kitto J.

H. C. OF A.
1950.

MIDLAND
RAILWAY
CO. OF
WESTERN
AUSTRALIA
LTD.
v.

FEDERAL
COMMISSIONER OF
TAXATION.

Kitto J.

the date of the resolutions, including the six per cent cumulative income debenture stock to the amount of £973,723 "with arrears of interest amounting to" £701,080; and it recited that the company was desirous of creating and constituting the reversionary certificates in accordance with the provisions of the scheme. The indenture contained the following clauses:—“(2) The Company shall forthwith create a series of Certificates to the total nominal amount of Eight Hundred and Nine Thousand Pounds each to be for the sum of One Pound or any multiple of One Pound and all such Certificates shall rank *pari passu* and shall entitle the holders of the Certificates to participate *pari passu* according to the nominal amount thereof in the distribution of the share of net profits of the Company to be from time to time distributed in manner hereinafter appearing. . . . (9) As and when the Directors shall upon any occasion determine to divide any profits the auditors or auditor of the Company shall certify the amount so to be divided without deduction of income tax and such auditors' certificate shall be forthwith communicated to the Trustees and the Company shall forthwith thereafter apply the amount so certified by the auditors or auditor as aforesaid in the redemption or purchase of the Certificates in manner hereinafter appearing. (10) The Company shall out of the moneys so available for distribution among the Certificate holders deduct and retain and pay over to the British and West Australian Governments a sum equal to the amount of income tax for the time being payable in England and Australia in respect of the profits so distributable and shall apply the balance of the said sum in the redemption of the Certificates in the option of the Company either (a) by drawings at par, (b) by the purchase of the Certificates by tender under par, or (c) by purchase in the market under par, the par value of the Certificates in each case being reckoned as the nominal amount thereof less the amount of income tax at the rate for the time being payable on the profits of the Company. . . . (14) The Certificates redeemed or purchased under the provisions aforesaid shall be forthwith thereafter cancelled by the Company and be handed over to the Trustees and endorsed Certificates shall be produced to the Trustees. (15) So soon as the total amount of the profits distributable as aforesaid among the Certificate holders and certified by the auditor or auditors prior to the deduction of income tax shall equal the amount of Eight Hundred and Nine Thousand Pounds together with the full amount of any moneys payable hereunder for costs expenses remuneration or by way of indemnity or otherwise or the Certificates shall all have been redeemed or purchased the Company shall thenceforward cease to

be bound to distribute any further part of the net profits to the Company pursuant to the provisions hereof. (16) The Certificate holders shall not be entitled in respect of the Certificates to rank against the assets in any winding up of the Company other than a winding up for the purpose of reconstruction in which case they shall be entitled to rank to the extent of the amount of the Certificates held by them respectively then remaining unredeemed against the surplus assets of the Company remaining after repayment of the amount paid or credited as paid on the ordinary shares for the time being of the Company and shall be entitled to be paid the full amount in respect of which they shall so rank as aforesaid before any further distribution shall be made among the holders of the said ordinary shares.” (The reference in cl. 9 to drawings is to drawings by lot in accordance with provisions contained in other clauses.)

It should be mentioned here that when the scheme was submitted to the holders of debenture stock and to the shareholders for their consideration, it was accompanied by a circular addressed to them by the directors of the company, which contained the following passages :—“In the absence of the Plan no material amount of interest on the £973,723 Six per cent. Cumulative Income Debenture Stock could be paid during the next few years, and the arrears thereon could not fail to be materially increased meanwhile. Under the Plan there will be issued to the holders of the £973,723 Six per cent. Cumulative Income Debenture Stock the following stocks :—

1. Second Mortgage Debenture Stock..	£600,000
This is equivalent to 61.62 per cent. on their present capital holding.	
2. New Unified Ordinary Stock ..	£373,723
This represents the remaining 38.38 per cent. of their present capital holding.	
New Unified Ordinary Stock ..	£146,058
This represents the Fifteen per cent. premium to which the holders are entitled if now redeemed.	
	£519,781
	£1,119,781
3. Reversionary Certificates ..	£701,080
This represents all arrears of interest to 30th June, 1910.”	

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H. C. OF A.
1950.
MIDLAND
RAILWAY
CO. OF
WESTERN
AUSTRALIA
LTD.
v.
FEDERAL
COMMIS-
SIONER OF
TAXATION.
Kitto J.

H. C. OF A.
1950.
MIDLAND
RAILWAY
CO. OF
WESTERN
AUSTRALIA
LTD.
v.
FEDERAL
COMMISSIONER OF
TAXATION.

Kitto J.

“ The advantages of the Plan to the Six per cent. Cumulative Income Debenture Stockholders are that they will at once have an interest-bearing security in respect of 61.62 per cent. of their capital, while for the remaining 38.38 per cent. and the premium of 15 per cent. payable on redemption they will have 86.66 per cent. of the entire Unified Capital Stock and thereby the control of the Company. Such holdings, in conjunction with their Reversionary Certificates, will permanently secure to them a like percentage of whatever there is to accrue either in capital or revenue from the Company’s Railway and Lands.”

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“ The plan will, in addition, enable the Company’s future Balance Sheets to be presented undisfigured by large amounts of arrears of interest upon its several Debenture issues.” (The reference to a fifteen per cent. premium was not explained to me.)

After the execution of the abovementioned indenture, reversionary certificates in accordance with its provisions were issued as follows:—

(a) to the holders of the £973,723 six per cent. cumulative income debenture stock, reversionary certificates for amounts totalling	£701,080
(b) to the holders of the company’s ordinary shares, reversionary certificates for amounts totalling	£60,705
(c) to the holders of the company’s founders’ shares, reversionary certificates for amounts totalling	£47,215
	<hr/> £809,000

By a supplemental indenture dated 8th June 1925, the rights attached to the reversionary certificates were modified by reducing the proportion of surplus profits to be set aside for redemptions from one-third to one-sixth, and by way of consideration the holders were given, in lieu of their existing rights in a winding-up for the purpose of reconstruction, a right in the event of a liquidation for any purpose or a sale of the company’s undertaking, to receive one-tenth of the surplus assets after payment of all the company’s obligations and debts including all costs and expenses.

As already mentioned, in the company’s accounts for the year ended 30th June 1943, provision was included for an amount of £A2,966 to be applied in redemption of reversionary certificates, and in the ensuing year that amount was so applied, the certificates redeemed being of the nominal value of £E17,331. Likewise, in the accounts for the year ended 30th June 1944, provision was made

in the accounts for an amount of £A3,089 to be applied in redemption of reversionary certificates, and in the ensuing year that amount was so applied, the certificates redeemed being of the nominal amount of £E26,589. All the redemptions were effected by means of purchases by tender.

Although the company's notice of objection claimed that either the £2,966 or the £3,089 was an allowable deduction, before me it was conceded that no portion of either sum which was applied in redemption of reversionary certificates issued to the holders of founders' shares or ordinary shares was an allowable deduction; but the company has not been able to ascertain exactly what proportion of either sum went to redeem those reversionary certificates. There have been considerable dealings with certificates over the years, and in some cases, where certificates have been sold in parcels, amalgamated certificates have been issued. A table prepared by the secretary of the company in respect of the certificates redeemed in the year ended 30th June 1945, which was put in evidence and accepted as correct by the respondent, shows that certificates to the nominal value of £16,279 are not traceable to the original holders, and the balance was issued originally to holders of six per cent. cumulative income debenture stock and holders of founders' or ordinary shares in the proportion of 10,182 to the former and 182 to the latter. I was informed that a table of a similar kind can be prepared in respect of the redemptions in the year ended 30th June 1944.

Insofar as a choice may have to be made between a portion of the £2,966 on the one hand and a portion of the £3,089 on the other hand, I am of opinion that it is the former which is relevant. That is to say, that if any amount is an allowable deduction in respect of the redemption of reversionary certificates, I think that it must be that amount which was actually expended by the company in the year ended 30th June 1944 in redeeming reversionary certificates which originally were issued to holders of six per cent. cumulative income debenture stock, and not the amount of the provision made out of profits in that year to be applied in the following year in redeeming such reversionary certificates. No argument to the contrary was in fact addressed to me.

Two main questions then arise, namely (1) whether the amount expended in redeeming reversionary certificates originally issued to holders of six per cent. cumulative income debenture stock is an allowable deduction under s. 51, and (2) if so, whether the company is entitled to succeed on this appeal having regard to its inability

H. C. OF A.
1950.

MIDLAND
RAILWAY
CO. OF
WESTERN
AUSTRALIA
LTD.

v.
FEDERAL
COMMISSIONER OF
TAXATION.

Kitto J.

H. C. OF A.
1950.

MIDLAND
RAILWAY
CO. OF
WESTERN
AUSTRALIA
LTD.
v.
FEDERAL
COMMISSIONER OF
TAXATION.

Kitto J.

to prove exactly what portion of the £2,966 was applied in redeeming reversionary certificates so issued.

(1) As to the first of these questions, two preliminary points are, I think, reasonably clear; in fact they were not denied by counsel for the commissioner. One point is that the interest amounting to £701,080 which accrued on the six per cent. cumulative income debenture stock between 1898 and 1910 never became payable prior to the issue of the reversionary certificates, the reason for this being that such interest was payable only out of surplus revenue of the company, and in that period there was no surplus revenue. The other point is that if the scheme evolved in 1910 had not been carried into effect, interest on the six per cent. cumulative income debenture stock would have become payable as and when the company had surplus income, and upon any such interest becoming payable and being paid the amount paid would have been an allowable deduction as being interest upon moneys borrowed for the purpose of carrying on the company's income-producing activities.

But the commissioner contends that when the scheme of 1910 was carried into effect the situation was materially altered. He argues that the holders of six per cent. cumulative income debenture stock received and accepted under that scheme, in satisfaction of all their rights, without discrimination between principal and interest, the £600,000 second mortgage debenture stock, the £519,781 new unified ordinary stock, and the £701,080 reversionary certificates; and that it is not permissible, having regard to the provisions of the indenture of 15th April 1911, to treat the reversionary certificates as having been issued in respect of the £701,080 unpaid interest. I do not agree with this contention. Even if, as was contended for the commissioner, no regard should be paid to the terms of the directors' circular, the correspondence between the amount of the unpaid interest and the amount of the reversionary certificates issued to the holders of the six per cent. cumulative income debenture stock, and the correspondence in kind between the rights conferred by the reversionary certificates and the rights which the holders of the six per cent. cumulative income debenture stock formerly possessed with respect to interest, appear to me to afford ample ground for regarding the reversionary certificates issued to those holders as referable specifically to their unpaid interest.

I am also of opinion that the issue of the reversionary certificates to those holders did not operate as a payment or satisfaction of

their unpaid interest. Its operation, in my opinion, was to alter the method by which that interest was to be paid. The principle of such cases as *Cross v. London and Provincial Trust Ltd.* (1), *Permanent Trustee Co. of N.S.W. Ltd. v. Commissioner of Taxation* (2), and *Inland Revenue Commissioners v. Oswald* (3), appears to me to be applicable. The consequence, in my opinion, is that the redemption of reversionary certificates issued to the former holders of the six per cent. cumulative income debenture stock partakes of the character of a payment of interest on moneys borrowed by the company for the purposes of its business.

It was further contended for the commissioner that if this conclusion should be reached, expenditure in redeeming such reversionary certificates is not an allowable deduction, because it is a payment out of net profits after they have been ascertained and the directors have determined to divide them. Reliance was placed upon *Commissioner of Taxation (W.A.) v. Boulder Perseverance Ltd.* (4), and *A. W. Walker & Co. v. Inland Revenue Commissioners* (5). In my opinion these cases do not require the conclusion that a payment of interest on money borrowed for the purposes of a business, when the contract under which it is payable makes the profits of the business the exclusive source for its payment, is to be held on that account not to be an allowable deduction under s. 51. If, as is the case here, in my opinion, interest is an outgoing incurred in producing the assessable income, it cannot with consistency be said to be payable out of taxable income. To say that it is payable out of profits or even out of net profits, is not to say that it is payable out of taxable income. Confusion may easily arise from cases dealing with the question whether particular payments are to be regarded as made in the course of ascertaining profits or out of profits when ascertained, because of the different senses in which the "profits" may be used. In this case, for instance, counsel for the Commissioner referred to the statement of the Privy Council in *Pondicherry Railway Co. v. Commissioner of Income Tax, Madras*, (6), that "a payment out of profits and conditional on profits being earned cannot accurately be described as a payment made to earn profits. It assumes that profits have first come into existence. But profits on their coming into existence attract tax at that point, and the revenue is not concerned with the subsequent application of the profits". But, as Lord Greene M.R. pointed out in *British Sugar Manufacturers Ltd. v. Harris* (7), the word "profits"

H. C. OF A.
1950.

MIDLAND
RAILWAY
CO. OF
WESTERN
AUSTRALIA
LTD.

v.
FEDERAL
COMMISSIONER OF
TAXATION.

Kitto J.

(1) (1938) 1 K.B. 792.

(2) (1940) 2 A.I.T.R. 109; 6 A.T.D. 5.

(3) (1945) A.C. 360.

(4) (1937) 58 C.L.R. 223.

(5) (1920) 3 K.B. 648.

(6) (1931) L.R. 58 Ind. App. 239, at pp. 251, 252.

(7) (1938) 2 K.B. 220, at p. 237.

H. C. OF A.

1950.

MIDLAND
RAILWAY
CO. OF
WESTERN
AUSTRALIA
LTD.
v.

FEDERAL
COMMISSIONER OF
TAXATION.

Kitto J.

was there used in the sense of "real net profits"; and the statement is inapplicable to a case where the relevant question is whether the payments were incurred in producing, not real net profits (which may approximate to taxable income), but assessable income which by definition includes gross income (s. 25). The effect of the indenture of 1911 is that the reversionary certificates are redeemable out of profits ascertained without allowing for the expenditure involved in such redemption; and those profits are not taxable income, but consist of assessable income less certain deductions only. The *British Sugar Manufacturers Case* (1) tends strongly to support the contention of the company in the present case, and in my opinion the proper conclusion is that the moneys expended in redeeming reversionary certificates which were issued to holders of six per cent. cumulative income debenture stock are an allowable deduction under s. 51.

(2) The second question, which arises because of the company's inability to differentiate completely between those of the reversionary certificates redeemed in the relevant year which were issued to the holders of the six per cent. cumulative income debenture stock and those which were issued to the holders of founders' shares or ordinary shares, was dealt with by counsel for the company in this way. He pointed out that the reversionary certificates were issued in 1911 to the debenture stock holders and to the holders of founders' and ordinary shares in the proportion of approximately seven to one; and he invited the Court to infer from that fact that in all probability seven-eighths of the certificates redeemed in any year would be certificates issued to the former class of holders. In my opinion, to accept this invitation would be to make a guess rather than to draw a permissible inference. I can understand that the commissioner might properly accept the suggested assumption as a business-like basis for an assessment; but I cannot adopt it as a basis of legal decision. For the reasons above stated, I am of opinion that the assessment is shown to have been excessive by reason of the refusal to treat as an allowable deduction so much at least of the £2,966 as the company can establish was expended in redeeming certificates issued to holders of the six per cent. cumulative income debenture stock. That amount, though provable, has not been proved before me; and in order that it may be worked out, and that the commissioner may have an opportunity of considering whether he should allow in its place a larger portion of the £2,966 which may be arrived at to his satisfaction even if not by strict

proof, I think the proper course is to remit the matter to the commissioner for his further consideration.

The order I make is that the appeal be allowed with costs, that the commissioner's decision on the company's objections be set aside, and that the objections be remitted to him for reconsideration.

Solicitors for the appellant: *Stone, James & Co.*

Solicitor for the respondent: *K. C. Waugh*, Crown Solicitor for the Commonwealth.

F. T. P. B.

H. C. OF A.
1950.
MIDLAND
RAILWAY
CO. OF
WESTERN
AUSTRALIA
LTD.
v.
FEDERAL
COMMISSIONER OF
TAXATION.